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CENTRE FOR MIDDLE EASTERN  
AND ISLAMIC STUDIES

# The Impact of the Exogenous Shocks of 1974 on Cypriot Trade

by  
Rodney Wilson  
1985



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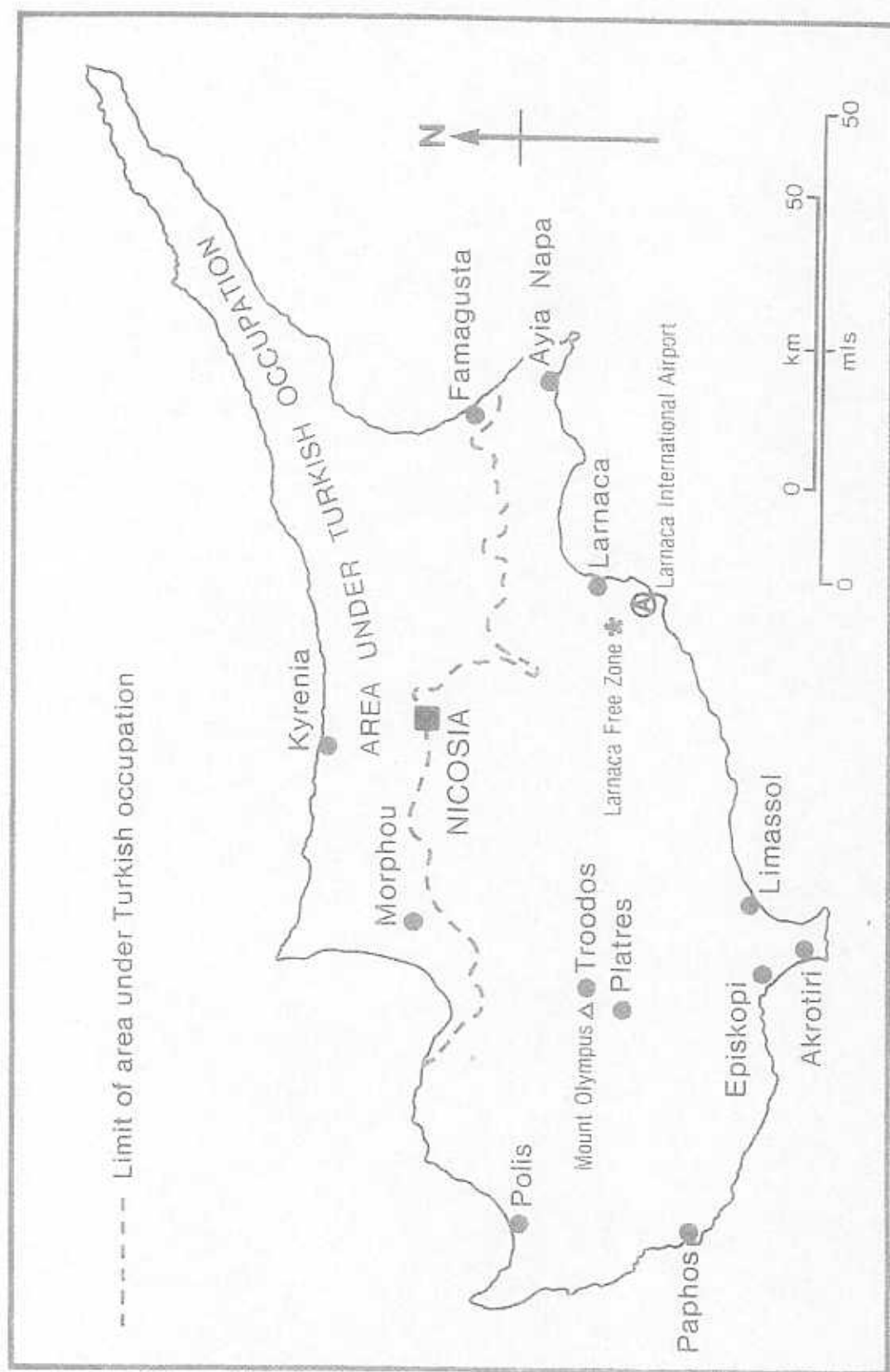
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# THE IMPACT OF THE EXOGENOUS SHOCKS OF 1974 ON CYPRIOT TRADE

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## THE IMPACT OF THE EXOGENOUS SHOCKS OF 1974 ON CYPRIOT TRADE

More than a decade has elapsed since the traumatic events of 1974 in Cyprus. Sufficient time has now passed to examine the economic significance of the events in historical perspective. Were they of long term significance for the Cypriot economy, or did they merely represent a short term set back? What were the implications for the country's trade, and are there any lessons other small, open, and equally vulnerable economies can learn from the Cypriot experience?

### 1.0 INTRODUCTION

Three major shocks affected the economy, and severely disrupted trade. First, like other small oil importing countries, Cyprus had to contend with the quadrupling in the price of oil. This not only affected its domestic energy prices, but also the cost of consumer and capital goods, as most of these were imported, and transport costs reflect oil prices. A second much greater catastrophe for the Greek Cypriot majority was the Turkish invasion, which resulted in the loss of 36.8 per cent of the island's land area, 80 per cent of the citrus and cereal production, 82 per cent of hotel beds, and 56 per cent of mineral production.<sup>1</sup> As the agriculture sector was the largest employer, and foodstuffs the major visible export, the loss of some of the most fertile areas of the island was potentially devastating for the economy. A third problem was the accession of the United Kingdom to the European Community in 1973. The United Kingdom was Cyprus' major trading partner, and the colonial power until 1960. As a consequence Cypriot exports were subject to the European Community's common external tariff, and there was little possibility of expanding sales of wine or Mediterranean agricultural products given European Community surpluses in these products.

### 1.1. Objectives

The aim of this paper is to examine the effects of these three exogenous shocks on Cypriot trade. The loss of territory obviously affected export volume, especially the quantity of agricultural exports. How did the economy respond, and was there a shift to other types of exports? The fall in exports, and the increase in the price of oil, clearly reduced the country's ability to pay for imports. What was the effect on import volume and import policy generally in this difficult situation? Finally, did the United Kingdom's accession to the European Community result in marketing problems for Cypriot exporters? Was there a change in the direction of trade as the country sought to find alternative markets?

### 1.2 The Turkish Cypriot Sector

The post 1973 figures quoted in this paper only refer to Greek Cypriot production and trade. As the Greek Cypriots account for four fifths of the population, and an even higher proportion of the total enumerated workforce, they were responsible for most of the island's production and trade prior to 1974. Furthermore Greek participation in the cash economy was much greater than that of the Turkish residents. Most Turkish Cypriots were farmers, and much of their agricultural economy was of a subsistence nature. Consequently their share of Cyprus' international trade was less than 10 per cent.

Greek Cypriot statistics do not include the Turkish sector after 1974, but since then the Turkish Cypriot authorities have issued their own statistical yearbook.<sup>2</sup> Trade data are in Turkish lira rather than Cyprus pounds, and given the high rate of inflation and consequent rapid depreciation of the lira, care has to be exercised when interpreting trends. To assess the Turkish Cypriot share of total Cypriot exports, the northern Cyprus trade data was converted into dollars and reconverted into Cypriot pounds. This calculation reveals

that Turkish Cypriot exports have risen from 10.6 per cent of total Cypriot exports in 1975 to 14.4 per cent in 1979. As there has been a Greek boycott of Northern Cyprus since the Turkish invasion, this export performance is all the more remarkable, as most goods are re-exported through Turkey which presents logistical problems. Imports were at an even higher level, amounting to 14.9 per cent of the Cyprus total in 1975 and 15.6 per cent in 1979.

Per capita imports are of course much less for the Turkish sector than for the rest of Cyprus, largely reflecting the lower income level of the Turkish community. However, the propensity to import on a given income level is higher for the Turkish sector, simply because the economy of northern Cyprus is so small. Dependence on mainland Turkey is decreasing nevertheless, as it accounted for 64 per cent of imports in 1975 but only 43 per cent by 1979. In contrast imports from the European Community rose from 24 per cent of the total in 1975 to over 42 per cent by 1979. Northern Cyprus is even more dependent on the European Community as an export market, with the United Kingdom alone accounting for over two thirds of Turkish Cypriot exports by 1979. Most of these are traded through one company, Polly Pek, whose interests range from the marketing of foodstuffs to textiles and clothing.

There is no doubt the Turkish Cypriot economy was affected profoundly by the events of 1974. Its trading pattern changed drastically, and there are many parallels, but also some contrasts, with how Greek Cypriot trade patterns have evolved. A comparative study, however, would be beyond the scope of this present paper. It is not certain what lessons, if any, could be drawn from such an investigation. Both communities suffered severe disruption, and the resettlement of the refugees has been a major challenge. Although



in close proximity, there were nevertheless separate economies. Physical separation has resulted in the different economic identities of the two communities being recorded statistically. The economies were at quite different levels of development in 1974, and the Greek economy was much larger. Hence it would be erroneous to draw any conclusions about the relative effectiveness of the Greek and Turkish authorities in responding to the events of 1974, merely by contrasting economic developments in the two parts of the island.

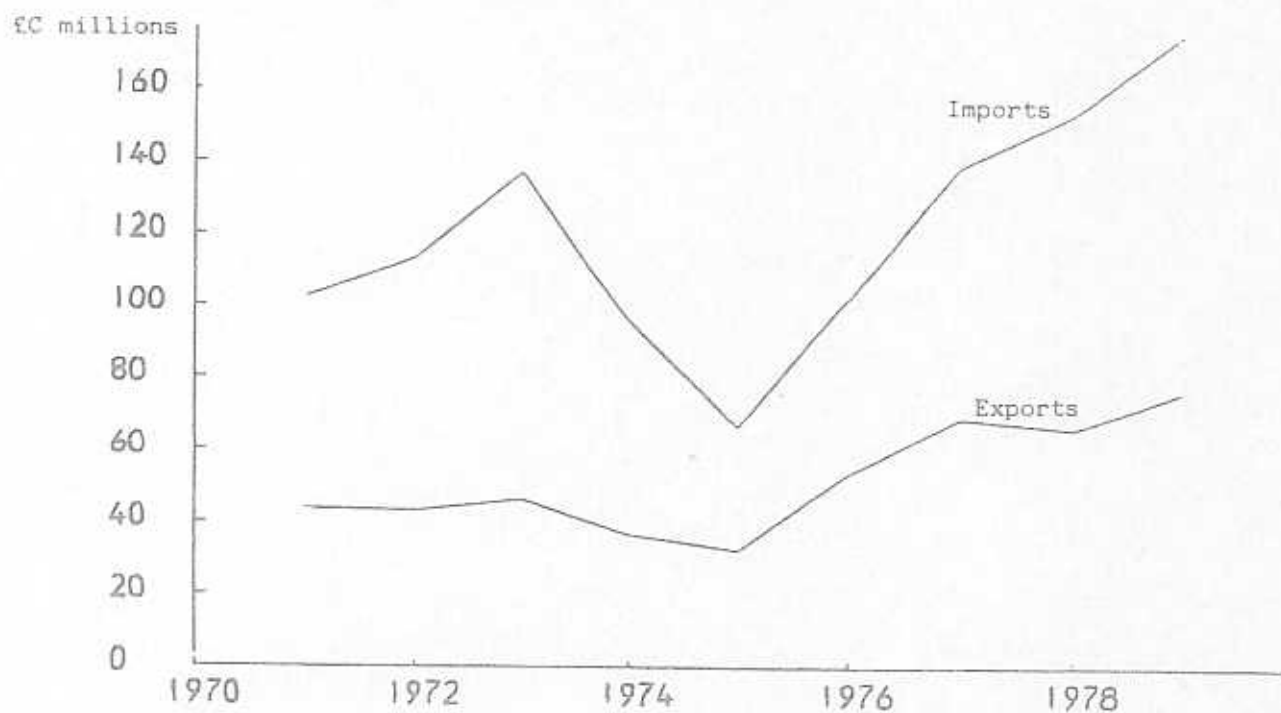
### 1.3 Aggregate Trade and Balance of Payments Effects

The overall effect of the exogenous shocks on Greek Cypriot trade is shown in chart 1. The data run only extends to 1979 as after then the price deflators were revised for both imports and exports. Both imports and exports fell in 1974, the former by almost 30 per cent and the latter by over 20 per cent. With imports falling more rapidly, the trade gap actually narrowed to just over £C60 million in constant prices in 1974 compared with over £C90 million the previous year. The fall in the demand for imports largely reflected the decline in personal income, as 40 per cent of the Greek Cypriot population had to abandon their homes and employment as a result of the Turkish invasion. Fortunately as most Greek Cypriot agricultural products are exported in the spring or early summer, which was before the Turkish invasion of July and August, the fall in export earnings was not as great in 1974 as it might have been. The loss of the island's major port at Famagusta, and the international airport at Nicosia, however, resulted in severe transportation problems for the remaining exports in the latter half of the year.

In 1975 imports fell even further, as it was the first full calendar year after the exogenous shocks. The total decline in imports since 1973 exceeded 50 per cent, while the corresponding decline in exports was 30 per cent. Exports were more resilient than

expected, and the opening of a new international airport at Larnaca meant air freight could recommence. Limassol replaced Famagusta as the island's major port, and it managed to handle most trade without serious delays being experienced. The trade deficit fell to £C33.8 million in 1975 in constant 1970 prices, its lowest level since the mid 1960s. The overall balance of payments situation suffered, however, because of the loss of tourist receipts, as with the Turkish occupation<sup>of</sup> the two most important tourist resorts, Famagusta and Kyrenia, the Greek Cypriots lost most of their hotel capacity. Fortunately the aid inflows partly compensated for the reduction in invisible earnings. Over £C23 million was received from international organisations, foreign governments and individuals for refugee relief

Chart 1: Imports, Exports and the Trade Balance



Note: Data in constant 1970 prices deflated using the Paasche formula. Separate import and export price deflators used.

Data source: Central Bank of Cyprus Bulletin No.69, December 1980. table 29, p.43, table 34, pp.50-51 and table 36, p.54.

in 1974, and £C26.5 million in 1975.<sup>4</sup>

Nevertheless, central bank reserves fell over the 1973-75 period from £C100.3 to £C79.3 due to the need to finance the invisible deficit. It was felt that it was more appropriate to use reserves and maintain the exchange rate at the same effective level vis a vis the currencies of the island's major trading partners. Devaluation was believed unlikely to improve export performance, and a rise in import prices would have meant further hardship. Instead import duties on a number of luxury consumer goods were increased, and the annual basic allowance for Greek Cypriot tourists travelling abroad was reduced from £C350 to £C150.<sup>5</sup> Controls were tightened on capital outflows, and the emigration allowance was reduced from £C10,000 to £C1,000. A £C1,000 annual limit was also imposed on the transfer of funds resulting from inheritance or real estate transactions. All these measures saved some foreign exchange, although their impact was probably more important psychologically than economically. They demonstrated the determination of the Greek Cypriot authorities to stabilise overseas payments, and prevent the exchange rate from falling and hence helped maintain both internal and external confidence.

## 2.0 EXPORT TRENDS

The Department of Statistics and Research in the Ministry of Finance in Nicosia calculates price and volume indices for Greek Cypriot exports and imports. These are published in both the Finance Ministry's Annual Economic Reports and the Central Bank of Cyprus Bulletin, the latter being the more up to date source. Export volume indices for the 1970s are shown in chart 2. Total export volume appears to have declined after 1973 to a much greater extent than might be expected by the loss of the Turkish Cypriot economy. The fall in export volume amounted to over 30 per cent, and as the Turkish Cypriot proportion of total exports was less than 10 per cent before 1974, as

Chart 2: Export Volume Index

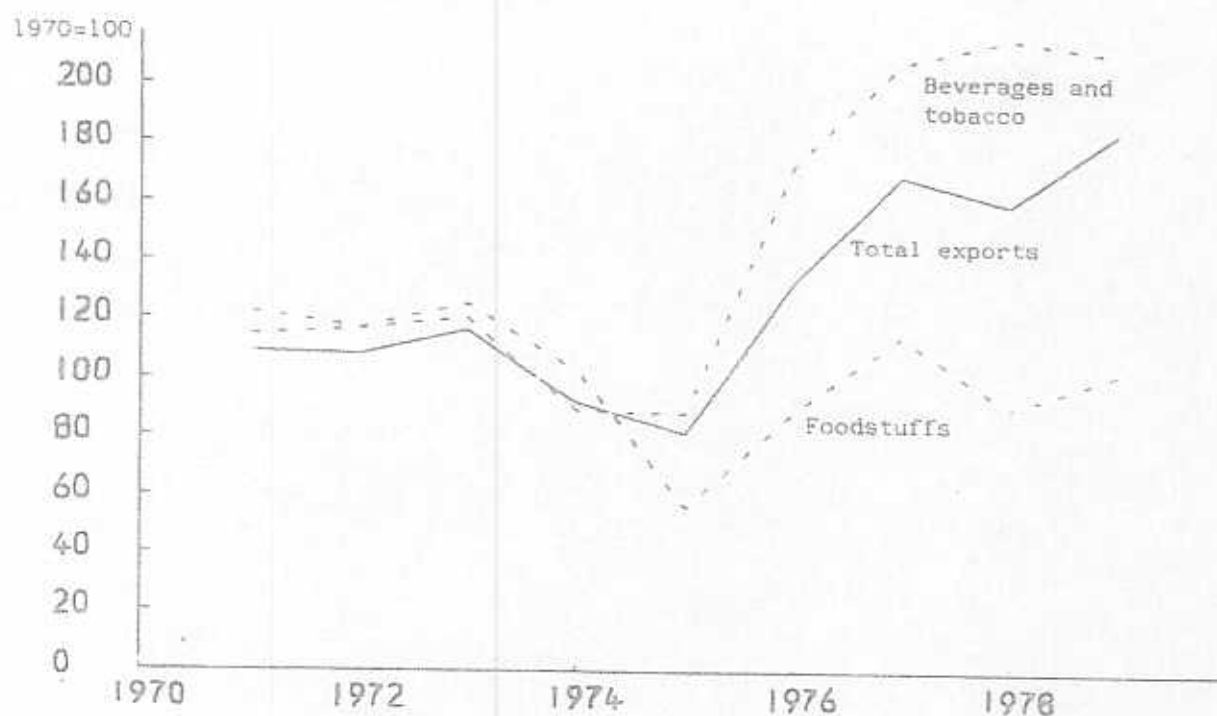
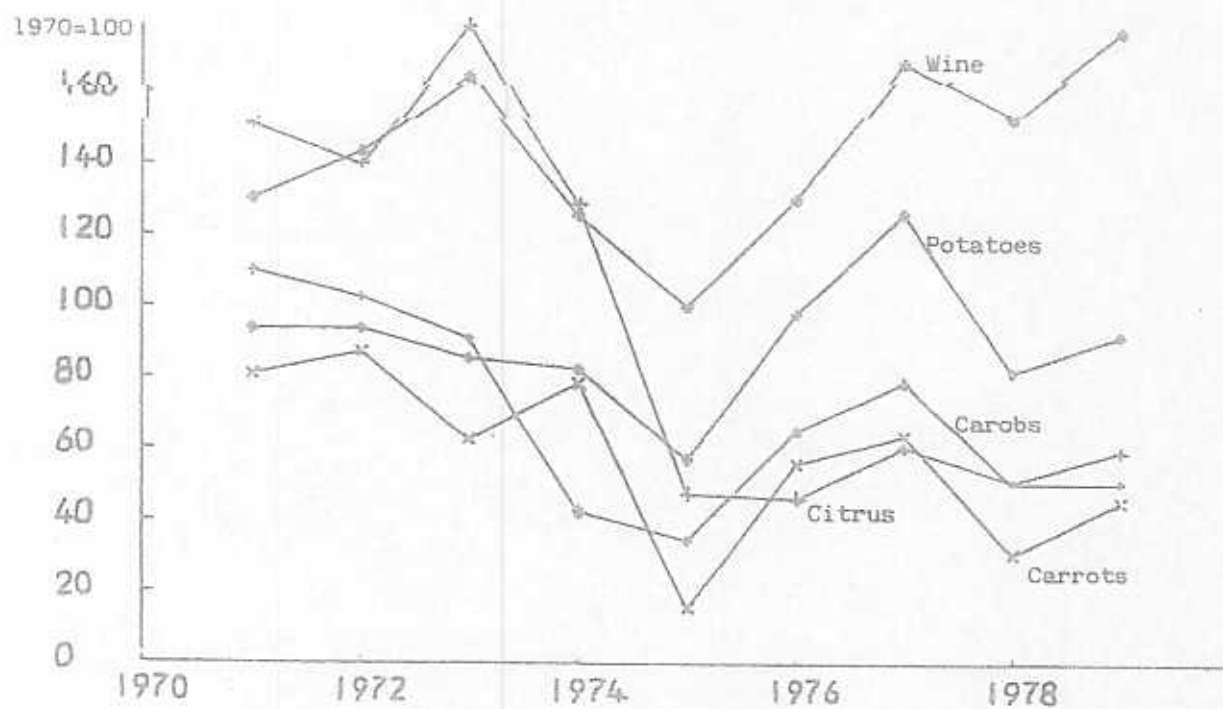


Chart 3: Agricultural Export Volume



Data source for both charts: Central Bank of Cyprus Bulletin No.69, December 1980, table 35, pp.52-53.

already indicated, this implies that Greek Cypriot exports fell by over 20 per cent. Not surprisingly the decline in foodstuffs was particularly marked, but beverages and tobacco were less adversely affected, partly because the major wine producing area is around Limassol in the south of the island, well away from the Turkish occupied areas.<sup>6</sup>

Chart 3 shows the volume trends for particular categories of agricultural exports. Citrus exports declined particularly rapidly after 1973, as most of these were produced in the northern part of the island which came under Turkish occupation, the most productive orange and lemon groves being <sup>in</sup> the Morphou area. Vegetables such as potatoes and carrots were less seriously affected. Potatoes, the second most important agricultural export after citrus before 1974, are mainly grown in the flat Ayia Napa area in the south east of the island, which remains under Greek control. Since 1974 potatoes have become the major Greek Cypriot agricultural export, the volume more than doubling over the 1975-77 period as chart 3 indicates.

These volume trends are confirmed in table 1, where the decade since the events of 1974 is contrasted with the previous decade. The trend was negative over the 1974-83 period for citrus exports for example, whereas for the previous decade citrus exports increased more rapidly than any other foodstuff. The overall increase in food exports after 1974 was less than half that of the previous decade. As table 1 shows, even the volume of potato exports only increased by a modest amount over the whole 1974-83 decade, despite the sharp rise over the 1975-77 period. Marketing rather than supplies seems to have been the major problem for vegetable exporters, especially with the United Kingdom's accession to the European Community, and increasing competition from other early potato producers such as Egypt and the Canary Islands.

Table 1: Primary Export Trends and Stability Indicators

		Increase/Decrease		Price instability		Volume instability	
		Slope of price trend	Slope of volume trend	Coppock index	MacBean index	Coppock index	MacBean index
Citrus	1964-73	7.35	13.56	12.44	5.71	11.33	11.41
	1974-83	9.52	-1.98	3.77	3.62	25.40	11.00
Grapes	1964-73	8.76	4.70	6.58	4.54	14.87	9.39
	1974-83	10.44	0.11	5.31	3.60	16.76	8.32
Rasins	1964-73	3.88	-3.23	3.91	3.72	30.87	15.99
	1974-83	7.19	33.59	14.42	14.00	39.51	25.14
Potatoes	1964-73	7.34	4.60	13.10	13.52	9.90	11.90
	1974-83	4.55	1.66	21.16	17.41	11.38	13.85
Carrots	1964-73	5.59	-1.23	33.65	21.92	18.12	14.88
	1974-83	8.07	-2.64	26.00	19.83	27.23	20.34
Carobs	1964-73	8.31	-3.16	6.57	2.05	12.27	9.92
	1974-83	11.69	-1.03	11.89	7.47	34.93	23.41
Total food	1964-73	5.86	7.45	3.37	3.34	4.80	5.80
	1974-83	7.09	3.02	8.60	5.62	10.27	6.88
Wine	1964-73	5.96	9.90	7.14	3.93	8.26	10.57
	1974-83	0.48	8.77	3.00	2.74	11.14	13.23
Tobacco	1964-73	-1.30	11.11	10.54	4.74	36.66	23.85
	1974-83	10.63	-7.50	22.49	31.75	57.05	46.88
Total beverages and tobacco	1964-73	4.01	9.22	3.24	2.97	6.81	4.74
	1974-83	2.56	8.56	4.22	4.02	14.71	8.93
Asbestos	1964-73	3.91	8.97	6.76	3.72	9.20	7.85
	1974-83	15.43	-3.30	6.61	4.54	12.95	8.69
Total minerals	1964-73	1.90	-0.16	8.05	7.89	8.10	6.76
	1974-83	8.19	-5.48	11.85	10.64	10.45	4.64
Total exports	1964-73	4.78	5.72	2.74	3.66	3.50	2.98
	1974-83	6.73	8.85	5.10	2.87	8.85	5.30
Total exports exc. minerals	1964-73	5.55	9.24	3.47	2.50	3.69	5.09
	1974-83	6.81	10.29	5.46	2.85	9.03	5.56

Notes. Slope of trend lines is parameter b, where trend is  $Y = a + bX$  estimated by OLS regression. The MacBean index is calculated by estimating the average annual percentage deviation from a five year moving average. The Coppock index is calculated by taking the average annual percentage deviation from an estimated trend variable.

Data sources: Central Bank of Cyprus Bulletins No. 28, December 1971, tables 30 and 31, pp.46-49, No. 49, December 1975, tables 32 and 33, pp.48-51 and June 1984, No.83, tables 34 and 35, pp.76-79.

Non-food primary exports also declined during the 1974-83 decade, especially mineral exports. The Turkish occupation of the mining facilities at Xeros resulted in a sharp decline in copper exports, the leading mineral export until 1974. Asbestos became the major mineral export over the 1974-83 decade, but although production was unaffected by the Turkish occupation, Cyprus' asbestos resources are limited, and extraction is increasingly costly. As a result the volume of asbestos exports fell during the post 1974 decade, in contrast to the expansion of the previous decade. Exports of other minerals such as iron pyrites and chromium virtually creased, yet the former was more significant than asbestos until 1971.

## 2.1 Export Prices

Export price trends for Cypriot primary commodities, as well as two indices of stability were calculated. The results are presented in table 1. The 1974-83 period witnessed a steeper rise in commodity prices than the previous decade as the relative slopes of the price trend lines show. Unfortunately for the Greek Cypriots, the price trend was less favourable for potatoes, the major food export, whereas citrus prices rose more rapidly. As already indicated however, it was the citrus exports which were lost due to the Turkish occupation, whereas potatoes were relatively unaffected. Wine exports, which were also mainly from the Greek Cypriot part of the island, suffered from virtually stagnant prices. There were increasing problems marketing Cypriot wines in the United Kingdom after the accession of the latter to the European Community, partly due to the common external tariff which gave a competitive advantage to continental European producers. Prices trends for mineral exports were much more favourable during the 1974-83 decade, but again the Greek Cypriots could not take full advantage of this as a result of the loss of the Xeros mines.

The price instability indicators further illustrate the



frustration for Greek Cypriot exporters in not being able to take advantage of favourable prices. Prices for citrus exports were much more stable during the 1974-83 period when Greek Cypriot exporters had lost most of their supplies, whereas potatoes, which were in greater abundance, experienced increasing price instability. The difference between the Coppock and MacBean results are generally less for prices than for volumes. Price instability was a result of developments in international markets over which Cypriot exporters had little control. Being relatively limited suppliers, the exporters were price takers, not price makers. When measuring volume instability over the 1974-83 period, however, it is preferable to use the MacBean results based on the moving average method. The deviations from the overall trends were considerable during the 1974-76 period, which is why the degree of volume instability is generally higher when the Coppock index is used.<sup>7</sup>

The responsiveness of Cypriot primary exports to price changes was estimated. These supply elasticity results are reported in table 2. For all food exports except raisins, which are only of minor importance, the price elasticity of supply fell for the 1974-82 period in comparison with the previous decade. This result is consistent with the relative price and volume trends reported in table 1. Export supplies became increasingly inelastic due to the limited potential of the Greek Cypriot held area for increasing agricultural production. Raisin exports rose as a consequence of the difficulties in marketing wine, as it became more profitable to use grapes for raisins, which were subject to fewer restrictions in export markets. The elasticity value for minerals was negative for the 1974-83 period, a result of the decline in mineral production despite rising prices in international markets.



Table 2: Price Elasticities of Export Supply

	Period	Intercept parameter (a)		Price elasticity(b)		R <sup>2</sup>	DW
Citrus	1964-73	0.83	(0.60)	0.80	(2.67)	0.47	0.91
	1974-83	5.78	(2.87)	-0.23	(-0.56)	0.38	1.35
Grapes	1964-73	1.20	(1.63)	0.69	(0.35)	0.33	1.29
	1974-83	4.30	(2.86)	0.64	(0.20)	0.50	1.49
Raisins	1964-73	10.84	(1.39)	-1.40	(-0.82)	0.78	1.35
	1974-83	-7.57	(-0.97)	2.54	(1.65)	0.23	0.77
Potatoes	1964-73	2.59	(3.12)	0.41	(2.30)	0.40	1.69
	1974-83	3.67	(4.06)	0.13	(0.67)	0.54	2.21
Carrots	1964-73	5.45	(5.85)	-0.18	(-0.92)	0.96	1.94
	1974-83	7.22	(4.66)	-0.66	(-1.96)	0.32	2.48
Carobs	1964-73	7.21	(6.51)	-0.60	(-2.56)	0.45	2.06
	1974-83	7.47	(3.05)	-0.71	(-1.40)	0.20	2.62
Total food	1964-73	1.76	(1.58)	1.35	(5.67)	0.80	2.06
	1974-83	3.02	(2.18)	0.30	(1.01)	0.11	2.31
Wine	1964-73	-4.15	(-2.10)	1.83	(4.33)	0.70	1.20
	1974-83	-0.52	(-0.45)	0.99	(0.40)	0.20	0.63
Total beverages and tobacco	1964-73	-5.98	(-2.64)	2.28	(0.57)	0.66	0.89
	1974-83	-4.32	(-0.62)	1.86	(1.26)	0.17	0.52
Asbestos	1964-73	-1.28	(-0.47)	1.27	(2.21)	0.38	0.90
	1974-83	5.73	(8.46)	-0.28	(-1.95)	0.32	1.54
Total minerals	1964-73	2.19	(1.95)	0.50	(2.02)	0.34	1.10
	1974-83	8.95	(8.84)	-0.95	(-4.52)	0.72	1.45
Total exports	1964-73	-1.54	(-1.79)	1.31	(7.06)	0.86	1.67
	1974-83	-2.63	(-1.60)	1.52	(4.36)	0.70	1.32
Total exports exc. minerals	1964-73	-3.70	(-3.15)	1.76	(7.04)	0.86	1.41
	1974-83	-3.51	(-2.07)	1.72	(4.74)	0.74	1.50

Note: Regression estimated of the form  $X = aP^b$ , where X = exports, P = export prices, a is the intercept parameter (when logs are taken) and b is the slope parameter. Figures in parentheses are t values, DW is Durbin Watson statistics.

Data sources: Central Bank of Cyprus Bulletins No. 28, December 1971, tables 30 and 31, pp.46-49, No.49, December 1975, tables 32 and 33, pp.48-51 and June 1984, No.83, tables 34 and 35, pp.76-79.

## 2.2 Export Diversification

Despite the decline in the price elasticity of export supply for primary produce exports, the overall elasticity of export supply was higher over the 1974-83 period than during the previous decade. When mineral exports are excluded from the total the elasticity value is even higher as the bottom line in table 2 shows. This is a result of the policy of diversification out of primary exports into manufactured goods. The high supply elasticity for total exports indicates the success of the policy. Supply elasticities could not be estimated for individual manufactured goods however, due to the heterogeneity of the products concerned, and changes in the product specification over time. Price changes may thus reflect changes in quality.

After the events of the 1974 it was realised that a change in economic policy was needed if export earnings were to be revived. As prospects for primary product exports appeared poor, the Greek Cypriot government saw the development of manufactured exports as imperative.

"The industrial reactivation policy is an integral part of the policy . . . to secure or replace lost sources of foreign exchange earnings."<sup>8</sup>

Furthermore it was recognised that manufacturing would have to be export orientated in any case, given the limited size of the local market.

"The strategy of the industrial programme has a strong export orientation owing to the insufficiency of domestic demand."<sup>9</sup>

Production indivisibilities meant certain types of industry could not be established without overseas sales, while such sales would also enable advantage to be taken of economies of scale.

Several schemes were introduced during 1975 which encouraged investment in manufacturing.<sup>10</sup> Firstly government guarantees were

given to banks advancing credit to firms lacking adequate security. Up to 75 per cent of the loan could be covered in normal circumstances, and 100 per cent in special circumstances. By February 1976 total outstanding government guarantees for loans to the manufacturing sector amounted to £C3.3 million. A second scheme involved the creation of a special fund by the Central Bank of Cyprus into which the commercial banks contributed 3 per cent of their deposits. The funds could then be borrowed by the banks at below market rates to finance loans for the purchase of machinery or new industrial buildings. This encouraged the banks to lend for industrial development, while at the same time it harnessed funds from banks which in the past had largely avoided industrial lending. During 1975 alone loans amounting to £C0.8 million were approved under this scheme.

A third measure provided that all expenditure on plant or machinery or factory buildings could be offset against income tax for a three year period after the Income Tax Law of 1975. A fourth measure was the Standards and Quality Control Law of 1975. Under this act a Standards Authority was established which laid down specifications for manufactured exports. The Standards Authority not only exercised control, but gave free advice to potential exporters on how to improve the quality of their products. A fifth measure was the Free Zone Law of 1975 which established free zone industrial estates near Larnaca Airport and Limassol port. The government spent £C500,000 on the Larnaca zone alone in building perimeter fences and providing basic infrastructure for the estate. Within the zones export industries were allowed to import all intermediate goods and raw materials tariff free.<sup>11</sup>

Sixth, an export credit insurance service was established in 1975. This service provided insurance cover for up to 90 per cent of any losses suffered by exporters as a result of payments defaults

by foreign importers. In addition the government provided a guarantee to banks involved in export finance that 90 per cent of all loans would be covered against default.<sup>12</sup> Under the insurance scheme guarantees amounting to fC2.4 million were given in 1975. Little recourse was made to the government by banks involved in export finance however, as there were few defaults on loan payments by export companies. Finally an Industrial Extension Service was instigated with the assistance of U.N.I.D.O., the United Nations Industrial Development Organisation. The footwear industry was advised on how to modernise their production techniques through the introduction of new machinery and the rationalisation of working practices. The clothing industry was advised about design, and foreign marketing consultants were engaged who had a specialist knowledge of consumer preferences in the United Kingdom and other European Community markets.

Chart 4 shows how the value of manufactured exports increased as a result of these measures. The value of clothing exports rose six fold in constant price terms over the 1974-79 period, while exports of footwear more than quadrupled. The share of manufactured goods in total exports more than doubled in 1975 as chart 5 shows, while by the end of the 1970s manufactured goods were the major category of exports, accounting for almost 45 per cent of the total. Such a transformation in the composition of exports may have occurred even if the events of 1974 had not taken place, but it seems unlikely that the composition would have changed as remarkably in such a short period of time.

### 3.0 IMPORT TRENDS

The exogenous shocks of 1974 reduced the demand for imports largely as a result of negative income effects. The demand for fuels was price inelastic in the short run, the major uses being for electricity generation, private motor vehicles, tractors and industrial

Chart 4: Major Manufactured Exports

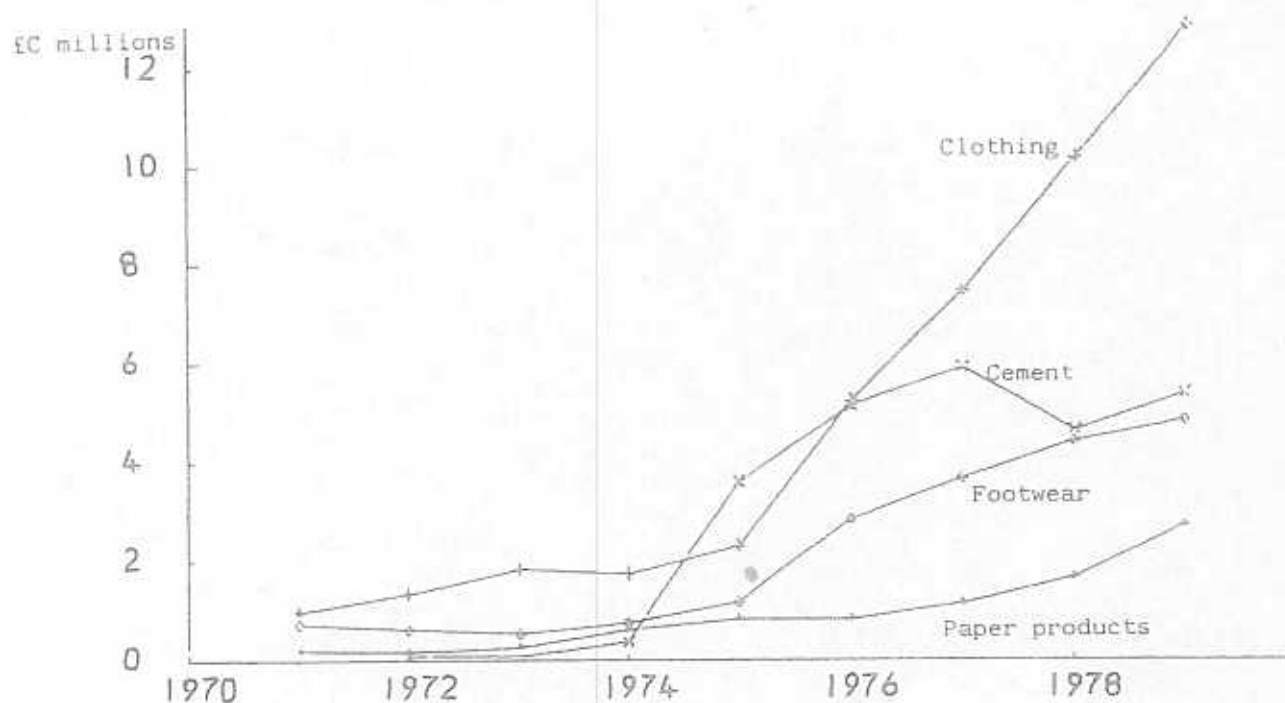
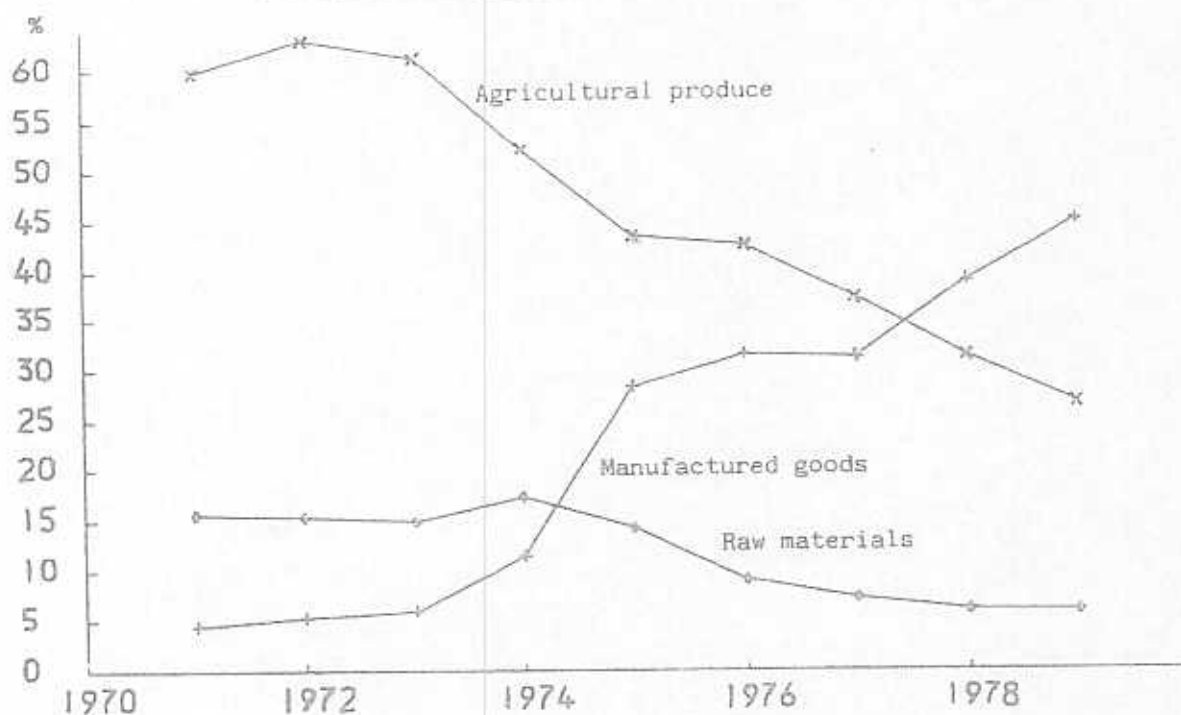


Chart 5: Composition of Exports



Data source for both charts: Central Bank of Cyprus Bulletin No.69 December 1980, table 33, pp.48-49. Price deflation for chart 4 into 1970 constant prices using export price data from table 34, pp.50-51.

plant and machinery. During the two decades prior to 1974 it seemed sensible to use oil as the island's main energy source given its proximity to the oilfields of the Middle East, and the low and stable price of imported oil. Substitutes for electricity generation such as coal were not available locally, and the limited supplies brought in for domestic consumption came from the United Kingdom and Australia. The Turkish coal mining industry only supplied the domestic market, and transportation facilities for the coal were poor. Hence when oil prices rose substantially in early 1974, alternative types of energy were not readily available, and the Cypriot power generating industry could not be converted to other types of fuel. Thus as oil requirements remained constant in spite of the price rises, foreign exchange savings had to be made elsewhere in order to finance the oil import bill.

The rising price of oil was passed on to consumers however, both through rising electricity prices, and increased retail prices for petrol. This reduced the real disposable income of both private and business consumers, and resulted in a modest reduction in the demand not only for oil, but imports in general. Before this effect had time to work fully however, the Turkish invasion of mid 1974 occurred, with much more devastating consequences for real disposable income. Gross domestic product at constant factor costs fell by over a third over the 1973-75 period, and even allowing for the loss of the Turkish Cypriot sector, the decline in Greek Cypriot disposable income certainly exceeded one fifth. Hence even if the propensity to import had remained constant in relation to income, the fall in income would have been expected to result in a substantial reduction in imports. In the event imports as a proportion of Gross National Product fell from 45 per cent in 1973 to 43 per cent in 1975. As during the decade up until 1973 the percentage had been rising at around one per cent per annum, the impact of the exogenous shocks is evident.

Chart 6 shows how the volume of the major categories of imports

Chart 6: Import Volume Index

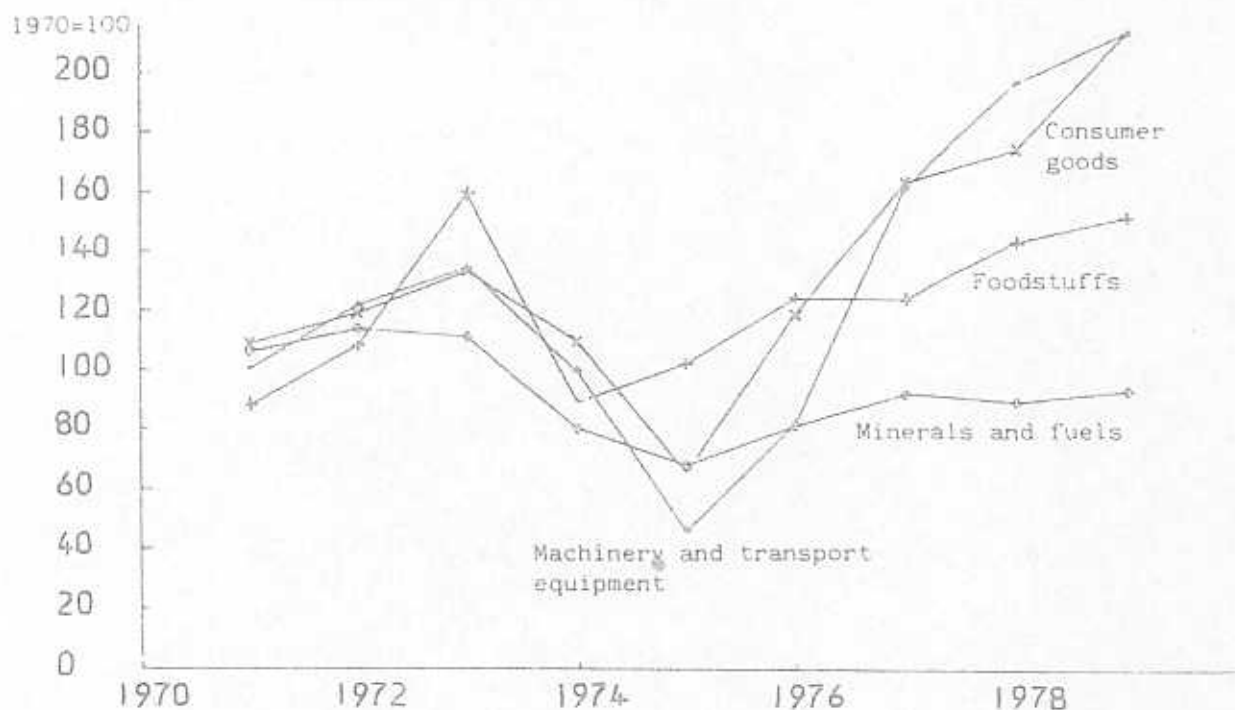
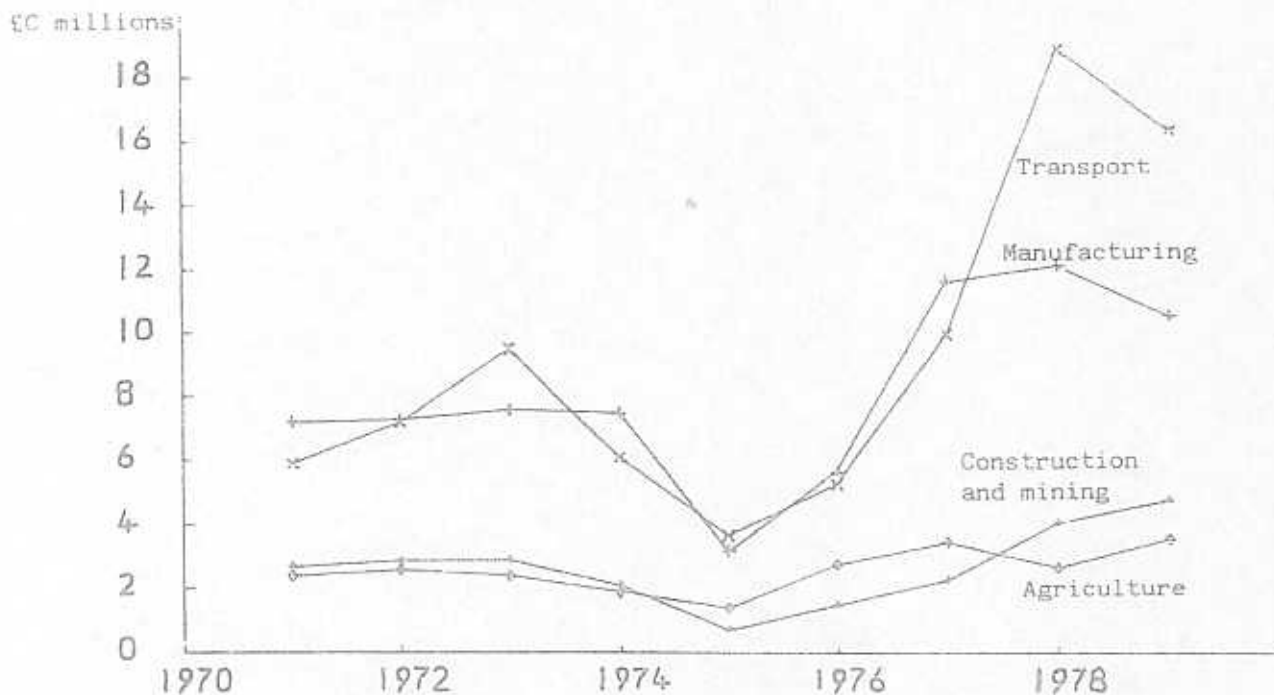


Chart 7: Value of Capital Goods Imports by Use



Data source for both charts: Central bank of Cyprus Bulletin No.69, December 1980, table 33, p.49 and table 37, p.55. Price deflation for chart 7 into 1970 constant prices using import price data from table 36, p.54.



changed during the 1970s. All categories decreased as a result of the 1974 exogenous shocks, but as might be expected, the fall in necessities such as imported foodstuffs was less than that for other categories of imports. The volume of food imports in 1975 was virtually the same as in 1971. Although incomes had fallen, and there was less demand for luxury imported foodstuffs, the dislocation of Cypriot agriculture as a result of the Turkish invasion actually increased the demand for imported necessities. The chart also shows how the volume of mineral and fuel imports fell, most of which are accounted for by petroleum. This was partly a result of the oil price rises, and the induced negative income effects, and partly because of the Turkish invasion. It is notable that when income rose again to pre 1974 levels by the late 1970s, the demand for minerals and fuels remained lower than earlier in the decade. This illustrates that the demand for petroleum was more price elastic in the long run than might have been expected in 1974, and conservation measures did prove effective to a considerable degree. As the chart illustrates, by the late 1970s when incomes were rising rapidly, it was consumer and capital goods which experienced the most rapid growth, a trend which has continued in the 1980s.

### 3.1 Capital Goods Imports

Not surprisingly imports of machinery and transport equipment fell the furthest in 1975 as a result of the exogenous shocks as Chart 6 shows. The dislocation resulting from the Turkish invasion resulted in a virtual cessation of new investment plans, and the only capital equipment imported were items which were subject to non-negotiable contracts. The fall in capital goods imports proved to be only temporary however, as by 1977 they had risen to a record level in volume terms. This was largely a consequence of the industrialisation drive which resulted from the measures taken in 1975



to encourage a diversification of economic activity away from primary resource exploitation.

As chart 7 shows, the value of capital goods imports by the manufacturing sector in constant prices almost quadrupled over the 1975-77 period to well in excess of its 1973 level. In contrast the rise in imports of agricultural machinery was much more modest. The increase in the value of transport equipment imported was the most rapid, this being mainly trucks for the industrial and construction sectors. Some cars used primarily for private purposes were also classified as capital goods imports, the distinction between private cars, self drive cars for tourists, and taxis being difficult to define precisely in practice. To some extent the rise in vehicle imports shown in chart 7 therefore reflects the increase in living standards of the late 1970s, even though officially those recorded here were capital items.

Income elasticities of demand were estimated for total imports and different categories of imports, and the post 1974 decade contrasted with the earlier decade. The results are presented in table 3. As might be expected the income elasticity of demand for all categories of imports increased in the post 1974 period, but the rise was most marked for consumer goods and capital equipment, whereas in the case of raw materials the increase was modest. The rising demand for capital equipment was largely a consequence of the encouragement given to investment. Expenditure on new machinery and other equipment increased by over a third between 1973 and 1979 in constant prices terms.<sup>13</sup> This was more than double the rate of increase during the previous five years. There seems little doubt that the exogenous shocks of 1974 proved a stimulus to investment rather than a handicap, as the Greek Cypriot authorities responded in a positive way when confronted with an adverse situation.

Table 3: Income Elasticities of Demand for Imports

		Income elasticity	t value	R <sup>2</sup>	DW
All goods	1964-73	1.12	(18.38)	0.98	1.80
	1974-83	1.96	(17.85)	0.97	0.89
Consumer goods	1964-73	0.92	(15.54)	0.96	1.43
	1974-83	1.82	(9.30)	0.91	1.03
Capital equipment	1964-73	0.93	(8.83)	0.91	2.00
	1974-83	1.58	(8.10)	0.89	2.30
Raw materials	1964-73	1.50	(14.04)	0.96	1.92
	1974-84	1.57	(10.63)	0.93	2.11

Notes: Regressions estimated of the form  $M = aY^b$ , where Y is GDP at constant factor costs, and M represents respectively total imports, consumer goods imports, and imports of capital equipment and raw materials. The intercept parameter is a, and b is the income elasticity. All the import statistics were deflated into constant prices using relevant import price indices. DW refers to the Durbin Watson statistics.

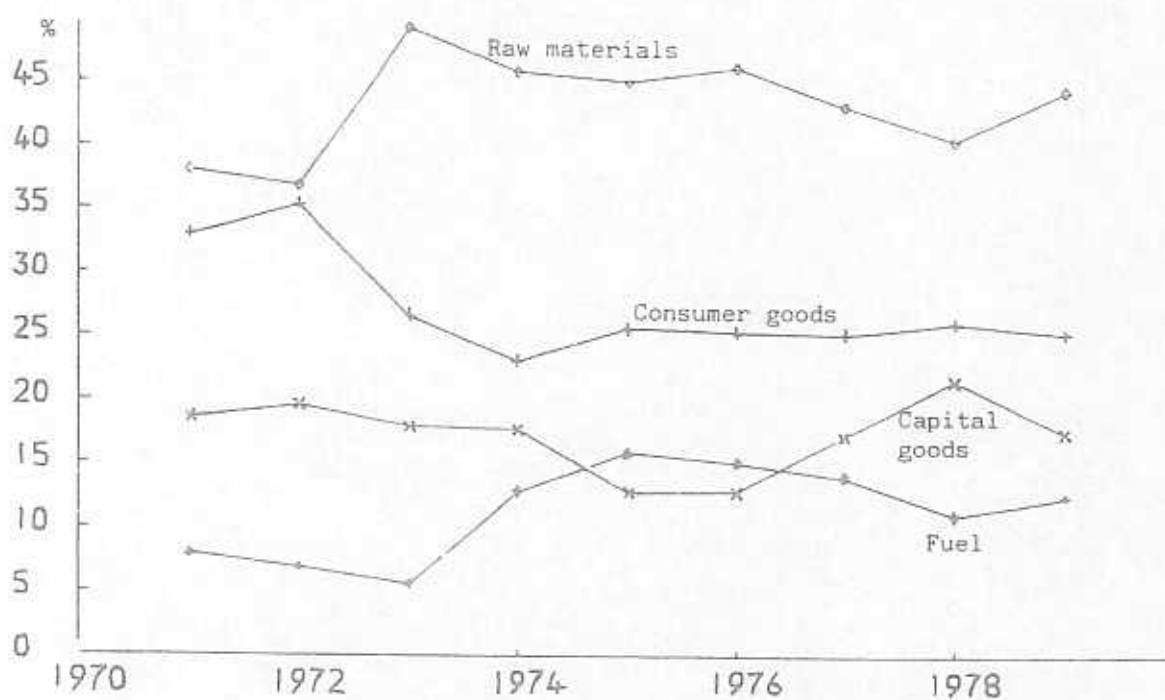
Data sources: Central Bank of Cyprus Bulletin No.28, December 1971, table 32, pp.50-51 and table 38, p.57, No.69, December 1980, table 33, pp.48-49 and table 43, p.61, No.83, June 1984, table 33, pp.74-75 and table 43, p.87.

From table 3 it is evident that there has been no trade-off between imports of capital and consumer goods as the income elasticities rose in both cases. With Greek Cypriot manufacturing industry being highly concentrated in the clothing and footwear sectors, it can serve only a small proportion of domestic consumer demand. As living standards have risen, demand has increased for consumer durables, especially cars, electrical goods and kitchen appliances, all of which have to be imported. As already indicated the island's manufacturing industry is primarily export orientated, an import substitution strategy being inappropriate given the limited size of the domestic market. Hence imports of capital and consumer goods are not substitutes.

Chart 8 shows the composition of imports. The rapid rise in the proportion of capital goods imports after 1976 is illustrated, with

capital goods accounting for over one fifth of the total by 1978. This is further evidence of the success of the policies to encourage investment enacted in 1975. These policies did not, however, involve any changes in tariff structure. Duties on imports remain a major source of government revenue, accounting for around one quarter of the total,<sup>14</sup> but most capital goods are exempt. This exemption dates back to the early post independence period, when tariffs on imported consumer goods were introduced. Tariffs are generally levied at modest levels however, the objective being to raise revenue, not to restrict imports because of infant industry protection. Cyprus has no quantitative restrictions on imports, apart from a few restrictions on imports of live animals and meat to prevent the spread of disease, and controls

Chart 8: Import Composition



Data source: Central Bank of Cyprus Bulletin December 1980, table 33, pp.48-49.

on drugs for safety reasons.<sup>15</sup>

It is also evident from chart 8 that the increase in capital goods imports was not at the expense of consumer goods. The latter accounted for around one quarter of the total from 1975 onwards. It was the petroleum price rises and increases in raw material prices in 1973 and 1974 that reduced the share of consumer goods imports, developments which also adversely affected imports of capital goods. The trends for capital and consumer goods imports are broadly similar, which reinforces the findings presented in table 3. Chart 8 demonstrates the success of the conservation measures to limit oil consumption, as the share of fuel imports fell in the late 1970s. This confirms the trends already discussed with respect to chart 6. The main measures included the installation of solar roof panels for heating and domestic hot water, and a switch in consumer preferences to cars with smaller, more fuel efficient, engines.

The elasticities of demand for capital goods and raw material imports with respect to sectoral outputs are presented in table 4. It appears that the elasticity of demand for capital goods imports by the industrial sector increased substantially during the post 1974 period in comparison with the previous decade. In contrast in the cases of agriculture and construction the elasticities declined, and the difference for the transport sector between the two periods was not significant. The elasticity of demand for raw materials declined in all cases, the falls being particularly marked for agriculture and transport. The negative elasticity values indicate that less raw materials such as fertilizers or petroleum were required in absolute terms, yet sectoral output still increased. As the demand by the transport sector was almost exclusively for fuel, this indicates the success of fuel saving policies.

The elasticity measures provide some indication of the import

Table 4: Sectoral Elasticities of Demand for Imports

<u>Industry</u>	<u>Capital Goods</u>			<u>Raw Materials</u>		
	<u>Elasticity</u>	<u>t value</u>	<u>R<sup>2</sup></u>	<u>Elasticity</u>	<u>t value</u>	<u>R<sup>2</sup></u>
1964-73	0.74	(7.97)	0.88	1.11	(11.58)	0.94
1974-83	1.11	(3.46)	0.60	0.31	(0.33)	0.13
<u>Agriculture</u>						
1964-73	1.63	(4.81)	0.74	0.69	(1.18)	0.15
1974-83	1.33	(0.99)	0.11	-0.37	(-0.29)	0.10
<u>Construction</u>						
1964-73	0.35	(1.65)	0.35	0.92	(10.47)	0.96
1974-83	0.30	(8.93)	0.91	0.82	(3.98)	0.66
<u>Transport</u>						
1964-73	2.14	(5.18)	0.77	0.82	(3.67)	0.62
1974-83	2.18	(11.57)	0.94	-0.61	(-0.74)	0.64

Notes: Regressions estimated of the form  $M = aO^b$  where M represents capital goods and raw material imports respectively, and O represents respectively industrial output, agricultural production, construction activity and transportation and communications provision. The intercept parameter is a, and b is the demand elasticity for capital goods and raw materials. The output values were at constant factor costs, while the values of capital goods and raw material imports were deflated into constant prices using the import price indices for each category. The Durbin Watson statistics were satisfactory except for agriculture over the 1974-83 period.

Data sources: Central Bank of Cyprus Bulletin No.28, December 1971, table 32, pp.50-51 and table 38, p.57, No.69, December 1980, table 33, pp.48-49 and table 43, p.61, No.83, June 1984, table 33, pp.74-75 and table 43, p.87.

intensities of production for the different sectors, and how imports are likely to grow in the future if current trends continue. The low import requirement of the construction sector is not surprising, as cement is produced in Cyprus, and manpower and building materials constitute much of the industry's inputs. The high import dependence of the transport sector also seems quite credible, as all vehicles in Cyprus are imported. More surprising is the relatively low elasticity of demand for capital goods imports by the industrial sector in relation to agriculture. It seems that although the exogenous shocks

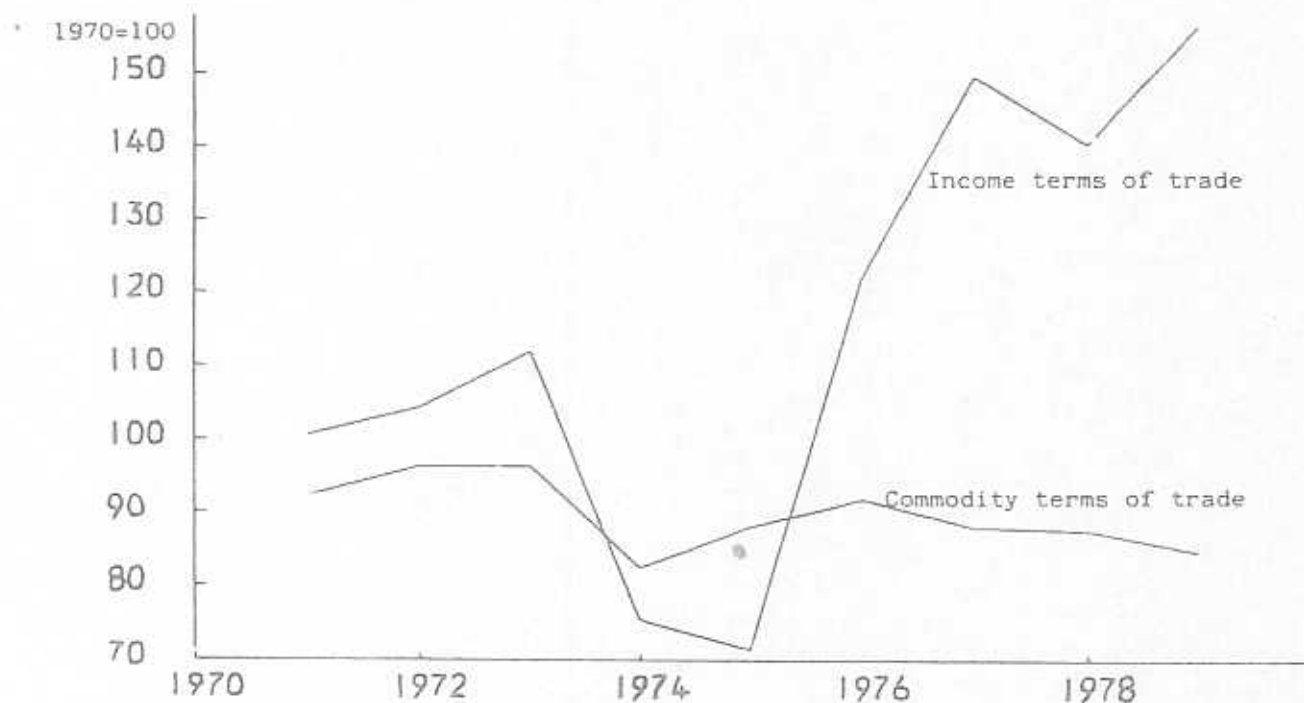
of 1974 adversely affected agriculture, and arguably benefitted industry, the overall effect on the capital goods import bill may in fact be positive. Although the capital intensity of the industrial sector is rising, it remains less than that for agriculture, at least when measured in terms of imported capital goods. As most capital goods are imported, this finding is certainly highly significant.

### 3.2 Terms of Trade

By examining import price trends in relation to export price trends, it is possible to ascertain how a country's international purchasing power changes over time. In other words terms of trade developments give one indication of a country's ability to finance imports. However, where capital account transactions are relatively important in relation to current transactions as in the case of Cyprus, and if invisible earnings are also significant, caution must be exercised in using the terms of trade in this way. Nevertheless although capital account movements compensated to some extent for adverse trade trends as was noted in section 1.3, trends in invisible earnings tended to reinforce movements in visible trade. Developments in invisible earnings will be considered further in sections 5.0 and 5.1.

Two measures of the terms of trade are illustrated in chart 9. The commodity terms of trade deteriorated sharply in 1974 due to the rising price of oil imports. Although there was some improvement in 1975 and 1976, the trend for the remainder of the 1970s was adverse, with the 1979 level significantly below that of the early 1970s. The income terms of trade takes account of export volume as well as export and import prices. As already indicated the volume of exports fell dramatically as a result of the Turkish invasion, and the consequent disruption of export production in 1974. Hence the decline in the income terms of trade was greater than that of the commodity terms of

Chart 9: Terms of Trade



Note: Commodity terms of trade =  $\frac{P_x}{P_m}$  where  $P_x$  is the export price index and  $P_m$  the import price index. Income terms of trade =  $\frac{P_x \cdot Q_x}{P_m}$  where  $Q_x$  is the export volume index.

Data source: Central Bank of Cyprus Bulletin No. 69, December 1980, table 34, pp.50-51, table 35, pp.52-53 and table 36, p.54.

trade. With the expansion of exports of manufactured goods from 1976 onwards however, the income terms of trade improved remarkably. This was entirely due to the expansion in export volume, as export prices remained low. It is important to note that the commodity terms of trade may have been even less favourable during the late 1970s than chart 9 shows. The prices of some manufactured exports rose, but this reflected improvements in quality. Hence buyers of Cypriot exports were getting even better value for money than the price trends would indicate.



#### 4.0 DIRECTION OF TRADE

Before independence most Cypriot trade was with the United Kingdom, the colonial power. Cyprus was part of the sterling area which facilitated payments with the United Kingdom, and the Cypriot pound was maintained at parity with sterling. The trading pattern of Cyprus corresponded to many other parts of the British Empire, with exchange controls applied to imports from non-sterling area countries until the 1950s. Manufactured goods were imported from the United Kingdom free of tariffs, and Cypriot citrus produce and sherry were exported to the United Kingdom. Imports of sherry and other types of alcohol from Cyprus were subject to excise duties in the United Kingdom, but no tariffs were applied.

Trade with the United Kingdom was also encouraged by the presence of British military personnel in Cyprus. This presence was largely a result of Cyprus' strategic position in the Eastern Mediterranean and its proximity to the Suez Canal through which much of the trade of the British Empire and Commonwealth passed. Around 15 per cent of the island's imports in the early 1950s represented supplies for the British troops. These supplies were sent through the N.A.A.F.I. direct from the United Kingdom. By 1960 however, just before independence, the proportion of Cypriot imports accounted for by supplies for the British troops had declined to just over 5 per cent.<sup>16</sup>

The United Kingdom still remains the largest single trading partner of Cyprus, although its share of both imports and exports declined sharply during the 1970s. As already indicated one major factor which affected Cypriot trade was the United Kingdom's accession to the European Community in 1973. This resulted in the common external tariff and quota system being applied to Cypriot exports. Imports were less affected, as the link with sterling was already broken with the United Kingdom's devaluation of 1967, and there were



few payments restrictions in force in Cyprus in any case as already indicated. Prior to the United Kingdom's membership of the European Community, an association agreement was signed between the Community and Cyprus on 19th December 1972. The aim of the agreement was to safeguard Cyprus' traditional trading links with the United Kingdom, although it was recognised that the island could not be exempted from long standing community policies.

As a Mediterranean country, Cyprus was in the fortunate position of being able to benefit from the European Community's Mediterranean policy. This treated the countries of the Mediterranean more favourably than more distant trading partners of the Community. Under the association agreement Cypriot exports to the European Community were subject to the common external tariff, including exports to the United Kingdom. However, as a Mediterranean exporter, Cyprus was entitled to a 70 per cent reduction in the tariff for its industrial exports, including men's and boys' outer garments and man made fibres, both of which were exports of growing importance.<sup>17</sup> Due to the Community's Common Agricultural Policy, the treatment of agricultural exports was less favourable, but a 40 per cent reduction of the standard tariff level was agreed for exports of both oranges and lemons. This concession was, however, subject to renegotiation in the event of a European Community surplus in citrus produce.

Cyprus for its part agreed to give most favoured nation treatment to all imports from the European Community. In addition the Cypriot government agreed to reduce its tariffs on European Community imports by 15 per cent from when the agreement went into force in 1972, and by further margins of 10 per cent in December 1975 and December 1977.<sup>18</sup> Cyprus was, however allowed to introduce a 20 per cent tariff for infant industry protection if necessary, but such protective measures could only be applied to 10 per cent of European Community exports. In practice this clause was not used, and Cyprus even agreed to cut

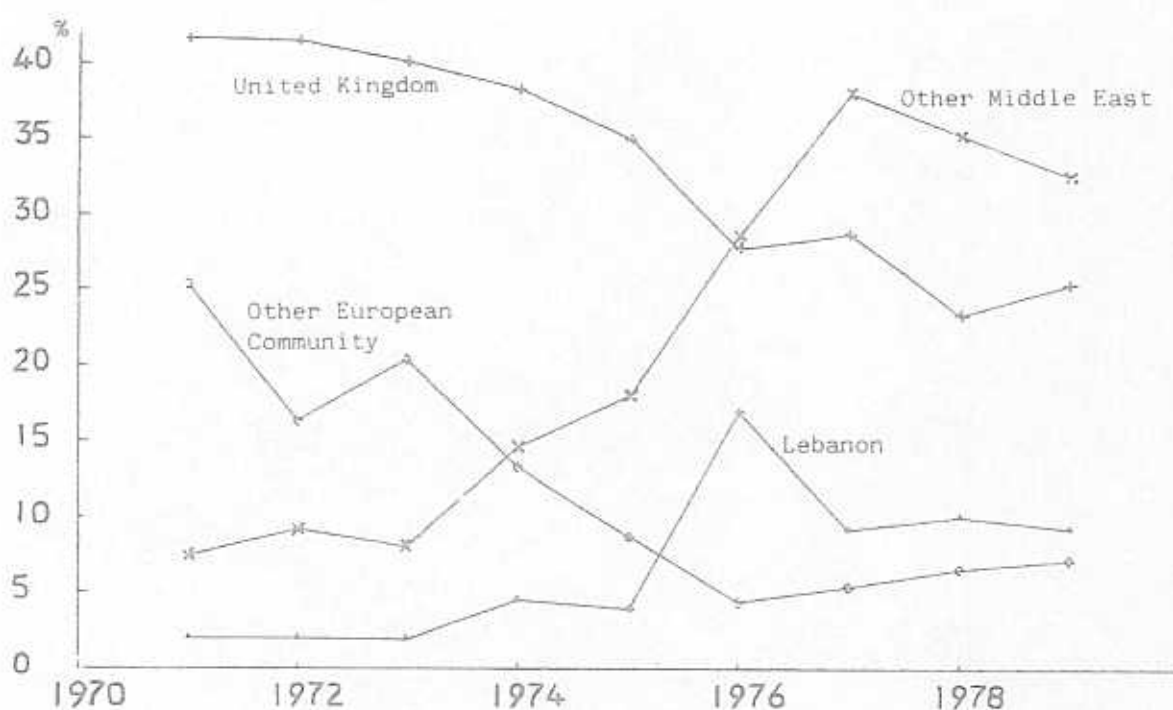
its import duties by 4 to 10 per cent for Community exporters who were selling products which were made in Cyprus.

#### 4.1 Export Markets

Although Cyprus applied no quantitative restrictions on European Community exports, its exports were subject to Community quotas, including those to the United Kingdom. The initial quota agreed for men's and boys' outer garments for example was 100 metric tons, a low limit even for a small economy with limited export potential such as Cyprus. In 1975, however, the quota for outer garments was increased to 500 metric tons,<sup>19</sup> partly as a result of European Community sympathy towards Cyprus following the events of 1974, but also because the Community's quota system was to be extended to cover exports to the United Kingdom for the first time. Less generosity has been shown in subsequent negotiations over Cypriot clothing exports. Worried by the threat to the European Community's textile and clothing industry by Third World producers, the Council of Ministers ratified the multifibre agreement which restricted these categories of imports. Although such restrictions conflicted with the Community's Mediterranean policy, the power of the European textile and clothing lobby has proved the stronger.<sup>20</sup> The multifibre arrangements were initially for a five year period only, but they have subsequently been extended. If they prove to be permanent, as seems likely, the scope for increasing Cypriot manufactured exports to western markets must remain limited.

Chart 10 shows the direction of Cypriot exports during the 1970s, with the decline in the share of exports to the United Kingdom illustrated. There was some attempt by the Cypriot authorities to diversify their export markets. The growth of the United Kingdom market was limited in absolute terms, partly reflecting the relatively low income rises in the United Kingdom in relation to other countries. The average real rate of export growth to the United Kingdom was

Chart 10: Direction of Exports



Note: Greece excluded from European Community figures as not a member until 1980.

Date source: Central Bank of Cyprus Bulletin, No.69, December 1980, table 30, p.44.

less than 2 per cent per annum during the 1970s. Cypriot exporters, however, had more knowledge of the requirements of the United Kingdom market than was the case with other countries, and well established contacts with import agents. Many of the distributors of Cypriot products in the United Kingdom were Greek Cypriot emigrants who had settled in north London and other British cities. There were no comparable communities of Cypriot exiles in other European countries, whose family ties could be exploited for business purposes.

With the United Kingdom's accession to the European Community, and the association agreement between the Community and Cyprus, it was hoped that the island would be able to market an increasing proportion of its exports in other European countries. In practice as chart 10 shows, the share of exports going to the other European

Community countries actually declined. The decline was not only in the relative share, but also in absolute terms. The value of exports to all European Community markets except Denmark and Belgium fell in constant prices, and in the cases of France and West Germany, there was a decline over the 1971-79 period even in current prices. This poor export performance was partly due to the European Community quota policy, which became increasingly restrictive with respect to exports of clothing in the late 1970s. Another factor was undoubtedly the lack of marketing agents in other European Community countries, apart from the United Kingdom.

Although the people of Cyprus are of Greek and Turkish origin, exports to these countries have never been significant. The Turkish market accounted for less than one per cent of Cypriot exports in 1971, and after the Turkish occupation of northern Cyprus, all Greek Cypriot (as well as Greek) trade with Turkey was embargoed. Greece accounted for under 4 per cent of Cypriot exports in the early 1970s, but since Greece joined the European Community the share of Cypriot exports destined for Greece has fallen to around 2.5 per cent.

Following the oil price rises and the rapid growth in the oil economies of the Arabian peninsula, the Cypriot authorities decided to concentrate on export promotion in these markets.

"The reopening of the Suez Canal presents a great opportunity for Cyprus and the commercial opening to the Arab countries will be the basic orientation of the export drive of the country."<sup>21</sup>

Opportunities were seen for exports of processed foodstuffs, and certain manufactured items including footwear, as well as building supplies. The construction boom in the Arabian Peninsula countries resulted in a great shortage of cement, which could not be met economically by European suppliers due to the transportation costs involved in shipping such a heavy commodity. Cyprus, because of



geographical proximity, could, however, viably serve this growing market. In 1974 there were excess supplies of cement available in Cyprus in any case, as the Turkish invasion disrupted construction work. Hence local supplies could easily be switched to export markets. Although subsequently the domestic construction industry revived, the Portland cement industry was rapidly developed so that it could serve both markets. The export success was illustrated by the fact that the value of Cyprus cement sold in the Arab world increased from a mere fC101,000 in 1973 to over fC10.5 million by 1977.

Saudi Arabia had become the second largest export market for Cyprus by 1977, with exports exceeding fC16 million, while exports to Kuwait and the United Arab Emirates were worth more than fC3 million for each market.<sup>22</sup> Cyprus not only supplied raw materials for the Arab construction industry, but several Cypriot firms won valuable contracts to undertake construction projects. Cypriot workers, who might otherwise have been unemployed at home, were able to secure employment in Saudi Arabia and some of the oil rich states of the Gulf. Over 10,000 Greek Cypriots were working in the Arabian peninsula by 1976, some for Cypriot companies and others for wholly Arab companies, but mainly in construction related fields. Their remittances were a significant source of invisible earnings for the island, as will be seen in section 5.0.

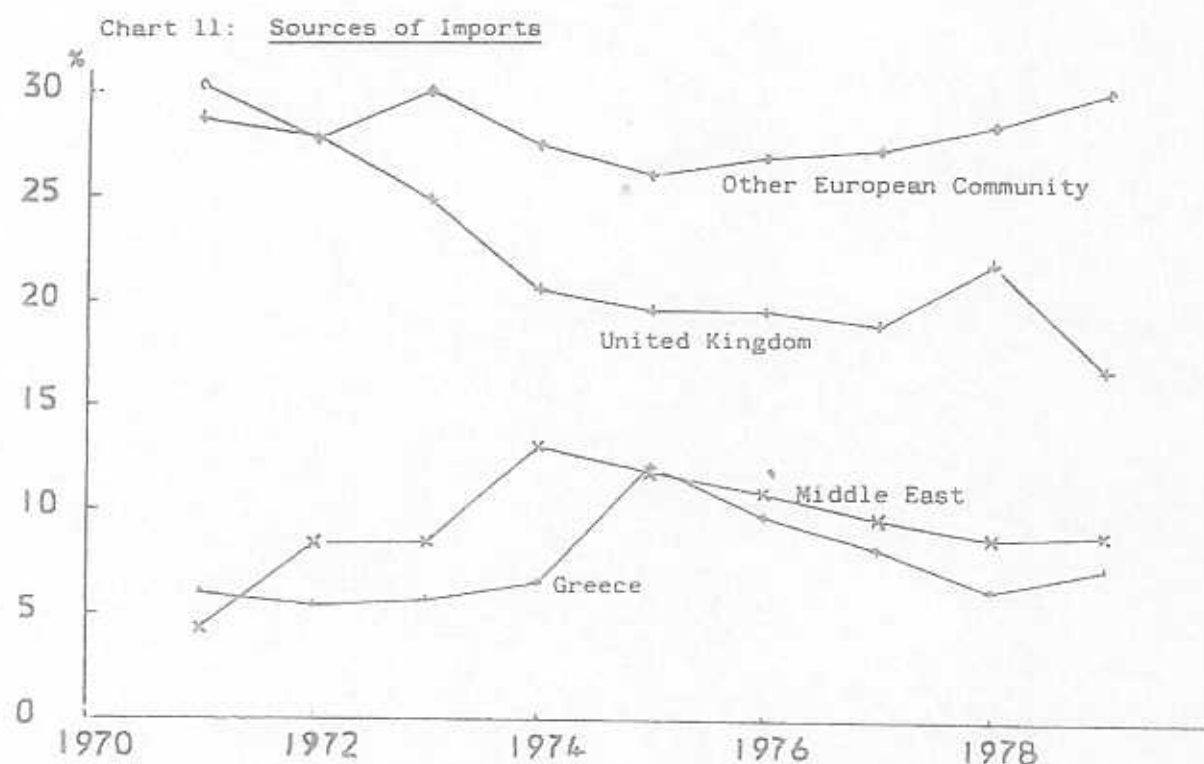
The rapid increase in exports to Lebanon in 1976 was a direct consequence of the Lebanese civil war, and the closure of the port of Beirut. The trade recorded refers to re-exports rather than exports, as most goods being shipped from the West to Lebanon were sent via Larnaca. The merchandise was transferred to small boats in Larnaca, and ferried to the Lebanese ports which remained open. Most of the re-exports were destined for the Christian held port of Jounie a few

miles north of Beirut, and a mere 125 miles, or a day's sailing, from Larnaca. The value of this trade has fluctuated considerably as the situation in Lebanon has evolved. The major determinants appear to be the openness of alternative trade routes to Lebanon, and the propensity of the Lebanese to purchase imports in a chaotic economic situation. From the point of view of Cyprus the main value of the trade lies in the transit fees for the use of Larnaca, and in the additional employment created for port workers and seamen.

#### 4.2 Import Origin

Although the results of the association agreement with the European Community were disappointing <sup>the</sup> from Cypriot point of view, as the share of exports destined for the Community subsequently declined, with imports the picture is very different. The United Kingdom was the major supplier of imports until 1972, but the other European Community countries increased their share of the Cypriot market during the 1960s. By 1973, the first year after the association agreement, the other European Community countries accounted for around 30 per cent of Cypriot imports as Chart 11 shows, the major suppliers being being West Germany and Italy. The share of imports from the European Community declined slightly in 1974, but this was due to the oil price rises increasing the value of imports from the Middle East. The decline continued in 1975, this being largely because Greece provided Cyprus with emergency supplies following the Turkish invasion. This accounts <sup>for</sup> the rise in the Greek share of Greek Cypriot imports to over 12 per cent. Nevertheless throughout the late 1970s the share of imports from the European Community countries grew steadily, especially imports from Italy. By 1979 the European Community, including the United Kingdom, accounted for almost half of Cypriot imports. With Greece's accession to the European Community in 1980 this raised the share to above the 50 per cent level.





Note: Greece excluded from European Community figures as not a member until 1980.

Data source: Central Bank of Cyprus Bulletin, No.69, December 1980. table 31, p.45.

The trade deficit with the European Community as a whole, including the United Kingdom, deteriorated dramatically during the 1970s. In 1971 Cypriot exports to the European Community were worth over half the value of imports from the Community, but by 1979 the proportion had declined to below one third.<sup>23</sup> Over the same period, however, exports to non-Community countries rose as a proportion of imports from 33.5 per cent to 57.5 per cent. The deficit with some of the major European Community countries was enormous by 1979. The value of exports to France was worth a mere 3.6 per cent of the value of imports, while the comparable figures for West Germany and Italy were 13.2 per cent and 4.2 per cent respectively. It was only with trade with the United Kingdom that the balance of trade situation remained

constant, with exports worth around two thirds the value of imports throughout the 1970s.

Trade trends since 1973 thus show that the association agreement has worked to the advantage of the European Community rather than Cyprus. Despite its economic difficulties Cyprus has implemented its part of the agreement, and extended trade preferences to imports from the European Community. Although tariff concessions have been granted to Cypriot exports however, the encouragement given to European Community citrus producers with Common Agricultural Policy, has reduced marketing opportunities for Cypriot citrus exports. The accession of Spain and Portugal to the European Community will undoubtedly worsen the situation, as Spanish citrus grovers increase their production in response to the high Community prices. If such prices had been paid to Greek Cypriot producers, then it would undoubtedly have been profitable to develop new orange and citrus groves to replace those lost due to the Turkish invasion.

Export sales of clothing have been hindered by European Community quota policies. It was unfortunate that the restrictive multifibre agreement came into force just as Cyprus was trying to expand its garments industry. Fortunately, however, few import restrictions have been imposed by Cyprus' major trading partners in the oil producing Arab countries. Cyprus runs a large trade surplus with countries such as Saudi Arabia and Kuwait. These countries have been prepared to accept Cypriot manufactured goods, even though most Cypriot oil imports are purchased from Iraq.<sup>24</sup> There has been no emphasis on reciprocity in trade policy on the part of Arab countries, and even those with payments difficulties, such as Egypt and Syria, have been prepared to run trade deficits with Cyprus without resort to additional restrictions.

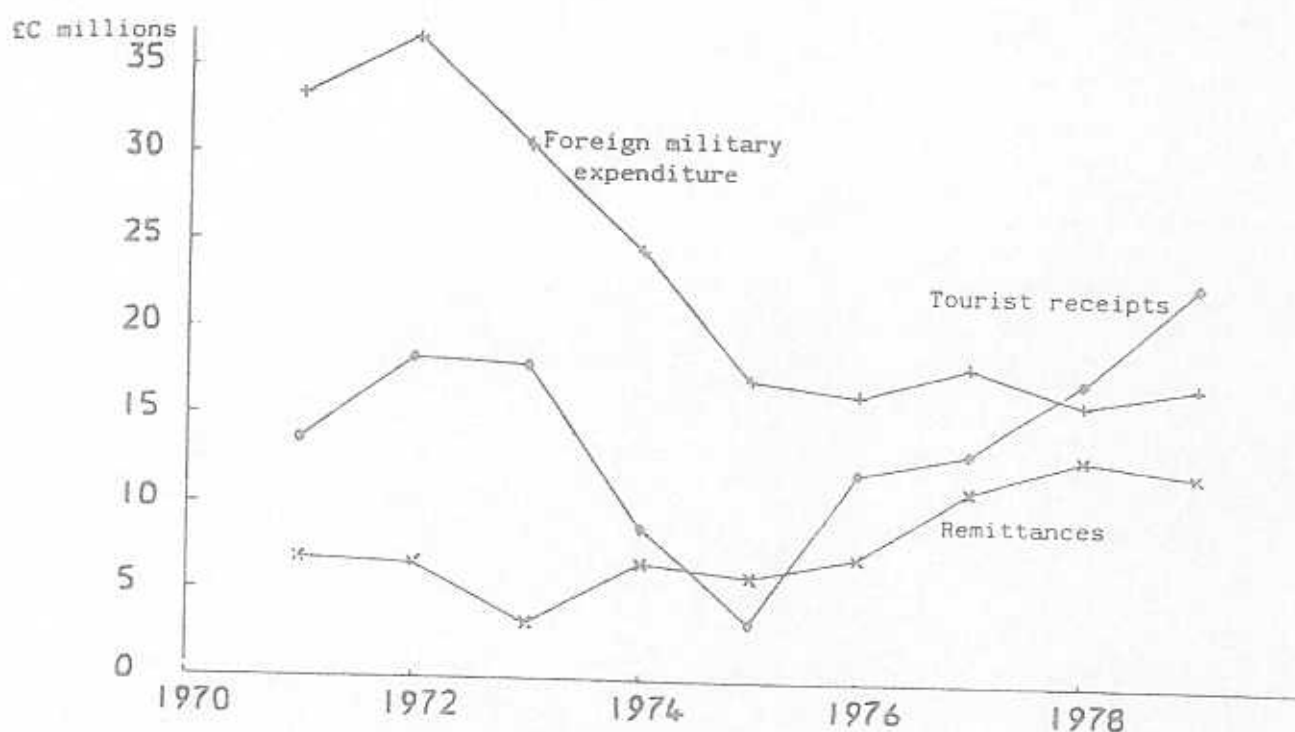


## 5.0. INVISIBLE TRADE

Although Cyprus has run a visible trade deficit every year since independence, this is offset to a considerable extent by a surplus on the invisible trade account. Historically the major source of invisible earnings was foreign military expenditure on the island, mainly by the British government. This was augmented by expenditure by the United Nations peacekeeping forces. In real terms there has, however, been a decline in the value of foreign exchange receipts from foreign military expenditure as chart 12 shows. This partly reflected the curtailment of defence spending by successive British governments. The value of this spending is limited from the Cypriot point of view in any case. The major benefit is the employment opportunities for local citizens on the British bases. The numbers employed have however fallen from 6294 in 1970 to 3620 in 1981.<sup>25</sup> Furthermore as the British troops largely consume goods imported from the United Kingdom, the local multiplier effects of military expenditure are restricted. In addition although the Cypriot government has tried to pressurise the United Kingdom into paying for the use of the bases, on a type of leasing arrangement, these efforts have not proved fruitful. Undue pressure has not been exerted, as Britain's political support has been wanted in other matters, especially in ensuring that the Turkish Cypriot regime in northern Cyprus does not receive international recognition.

Remittances from Cypriots working abroad are also of some significance as a source of invisible earnings. During the 1950s and early 1960s there was some emigration to the United Kingdom, especially of former civilian employees on the British bases. This migration was partly because of the unsettled security situation at the time, but also it reflected the fact that there were often more opportunities in the United Kingdom for these English speaking people. At that time the immigration laws of the United Kingdom were less

Chart 12: Invisible Earnings



Data source: Central Bank of Cyprus Bulletins No.49, December 1975, table 24, p.38 and No.69, December 1980, table 25, p.39. Price deflation into 1972 constant prices using general wholesale price index from table 40, p.58.

restrictive. After 1974 there was a new emigration wave largely in response to the employment opportunities which arose in the Arabian oil exporting states which were short of skilled labour. The migrants went both on their own and as employees of Cypriot construction companies which had won contracts in the Arab states.

This migration brought more benefits to Cyprus than the earlier migration to the United Kingdom. As whole families went to the United Kingdom, the inflow of remittances was less, with few immediate relatives left in Cyprus. In contrast it was mainly men only who sought employment in the Arab states. Furthermore the migration to the Arab states was of a more temporary nature. The migrants mostly worked on a short fixed contract basis, but brought their capital and

their skills back to Cyprus at the end of the contract.

### 5.1 Tourist Earnings

As chart 12 shows, tourist receipts became more significant than foreign military expenditure in 1978. This might have happened in 1974 had it not been for the exogenous shocks of that year. The petroleum price rises resulted in a recession in Western Europe and the United Kingdom which curtailed holiday bookings. Longer-haul destinations such as Cyprus were more adversely affected, as the rising fuel costs meant surcharges had to be imposed for the air travel component of the holiday package. Bookings were therefore lower even before the events of the summer of 1974, but the invasion and its aftermath was disastrous for the Cypriot holiday trade. The tourist industry quickly recovered however, with new hotels being constructed at Limassol, Paphos, Larnaca and Ayia Napa to replace those lost in Famagusta and Kyrenia.

The tourist industry in Cyprus developed originally largely due to the British military presence on the island as the troops and their families used their local leave to visit different places of interest. Relatives from the United Kingdom came to visit the troops stationed on the island. The tourist industry was given a further boost in 1966 when exchange controls were tightened in the United Kingdom due to the sterling crisis. British holiday makers going abroad could only take £50 out of the United Kingdom except if they visited sterling area countries. As Cyprus was in the sterling area, it was one of the few Mediterranean destinations where British holidaymakers could spend as much as they wished. The specialist British holiday firm, Exchange Travel, promoted Cyprus in the United Kingdom market, along with Malta and Gibraltar. As Cyprus was further away than these other two destinations, it could only attract higher income earners, but there were sufficient of these visitors to build

up a profitable, if limited, tourist industry.

Chart 13 shows how receipts per hotel bed, one measure of profitability, were extremely high in the early 1970s. The 1973 and 1974 period witnessed a dramatic decline as few visitors came to Cyprus during these years, but it is remarkable how rapidly receipts per hotel bed recovered. Of course there were few hotel beds available in the Greek Cypriot sector by the second half of 1974 as chart 14 shows. The high occupancy rate for the remaining rooms increased profitability however, and encouraged investment in new hotel development. One positive factor was the increasing number of expatriates from Europe and the United States normally resident in the Middle East who choose to take short spells of leave in Cyprus. These were often high income earners, and in the aftermath of the oil price increases, many more skilled Europeans and Americans found employment in the Arabian Peninsula. In this sense the oil price increases of 1974 brought benefits, which were accentuated by the demise of Beirut as a recreation centre. Cyprus Airways started direct flights from Larnaca to Jeddah, Abu Dhabi, Bahrain and Kuwait not only to serve Cypriot expatriates, but also to attract European and American workers and their families from the Gulf.

Returns on investment in the tourist sector appear to be high not only for private entrepreneurs, but also for the Greek Cypriot economy as a whole. One measure of social benefit is the ratio of foreign exchange earnings per unit of investment. Over the 1979-81 period this averaged 2.6 for agriculture, 2.9 for manufacturing, but 4.6 for the tourist sector. Although insufficient data were available for fuller social rates of return comparisons to be made,<sup>26</sup> this measure indicates how investment in tourism yielded a much greater amount of foreign exchange earnings than investment in activities that generated visible exports. The depreciation on fixed capital

Chart 13: Tourist Receipts per Visitor and per Hotel Bed

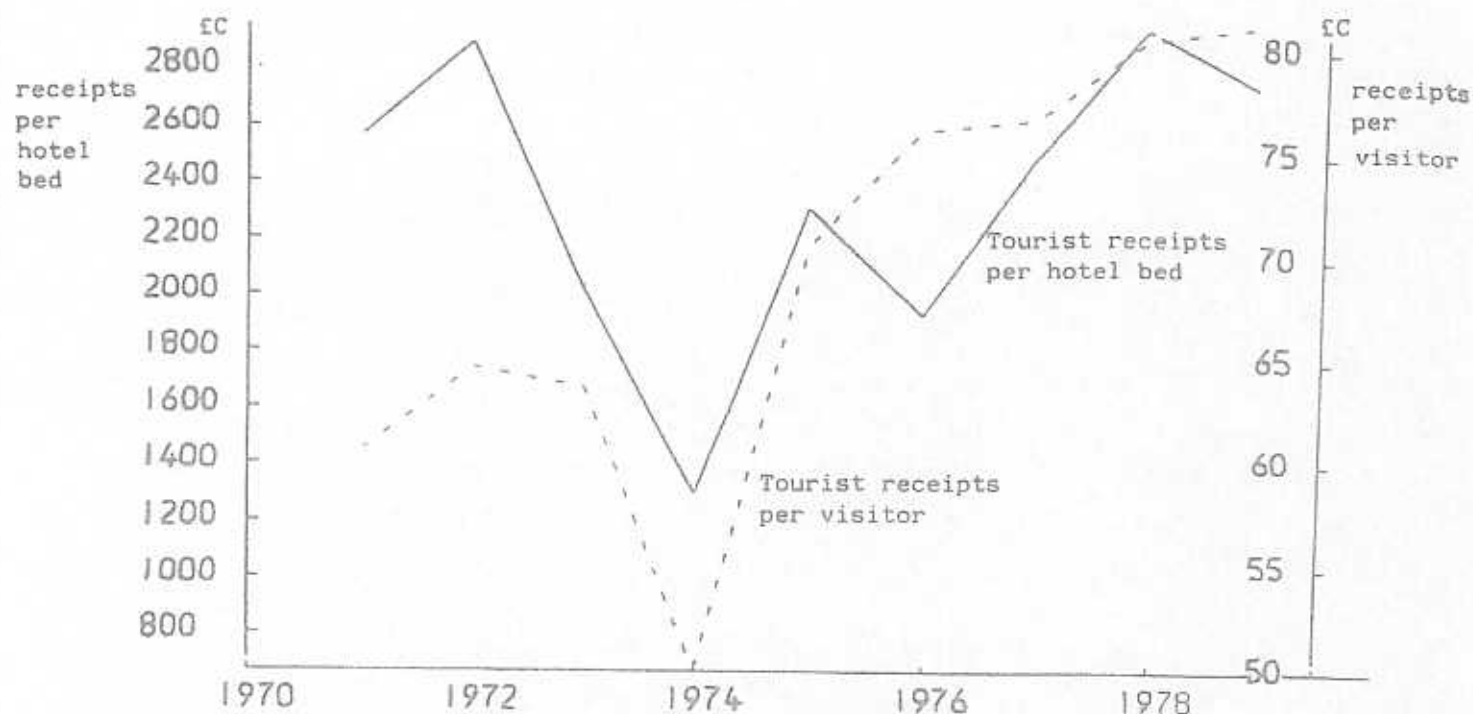
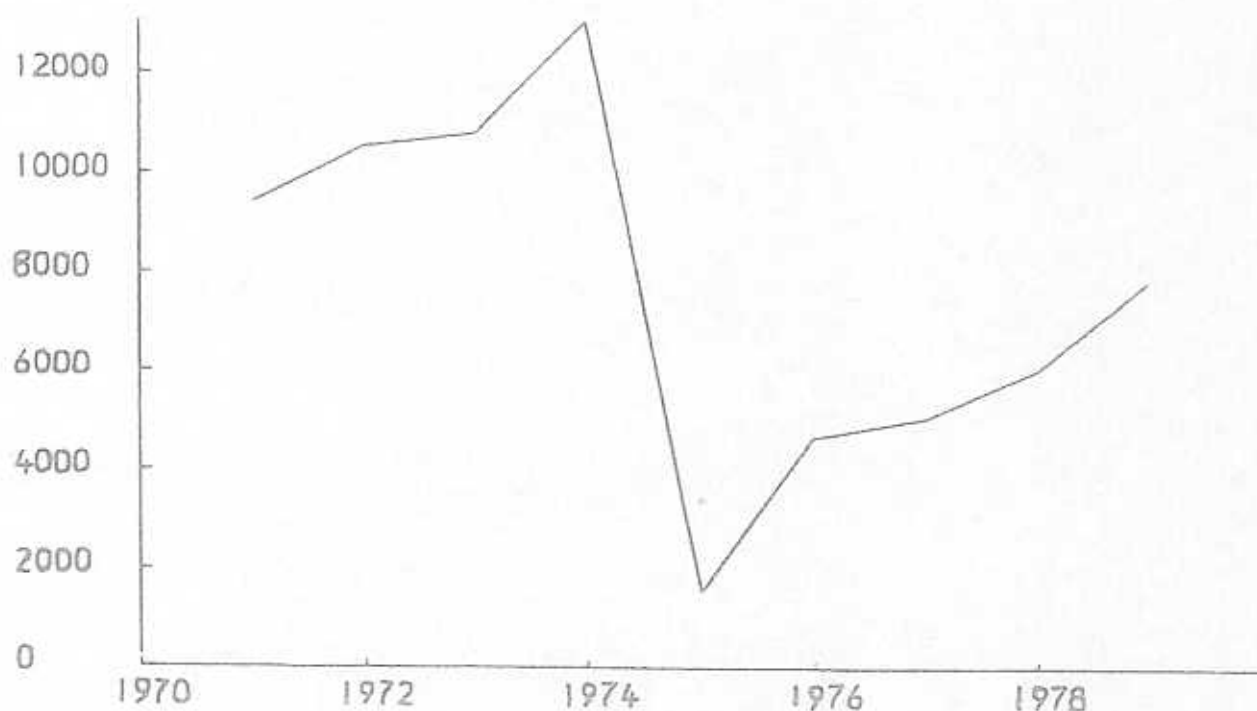


Chart 14: Number of Hotel Beds



Data sources for both charts: Central Bank of Cyprus Bulletin No.49, December 1975, table 24, p.38, No. 69, December 1980, table 25, p.39 and table 50, p.66. Data on hotel beds from Statistical Abstracts, No.18, 1972, table 21, p.79, No. 20, 1974, table 19, p.74, 1979-80, No's. 25 and 26, table 6, p.59. Price deflation for chart 13 into 1972 constant prices using general wholesale price index from Central Bank of Cyprus Bulletin No.49, table 40, p.58.

investment in hotels and holiday apartment complexes is also less than is the case with movable assets such as industrial and agricultural equipment. This strengthens the case for even more investment in the tourist sector.

## 6.0 CONCLUSIONS

Greek Cypriot trade has proved remarkably resilient when confronted with the exogenous shocks of 1974. The Turkish invasion resulted in the loss of a major proportion of the cropped area, and agricultural exports consequently suffered, especially citrus exports. Rather than bemoaning their losses however, the authorities drafted a series of Emergency Action Plans to diversify the economy, and encourage exports of manufactured goods. By 1976 exports were at a record level in volume terms, with clothing, footwear and cement exports expanding rapidly. The loss of agricultural exports was nevertheless unfortunate, as price trends for most food exports were more favourable during the post 1974 decade than previously, and agricultural price stability was greater for citrus produce.

Both the oil price rises and the loss of exports due to the Turkish invasion resulted in a curtailment of imports. Capital goods were particularly adversely affected, but they soon recovered, partly due to government's measures to encourage investment. The growing export proceeds from manufactured goods helped pay for these imports without severe balance of payments strains. This was fortunate as the income elasticity of demand for imports rose substantially during the post 1974 period. As living standards recovered, imports of consumer goods also grew, but this does not appear to have been at the expense of capital goods imports. The industrial sector's elasticity of demand for capital goods imports is surprisingly low in any case. It also appears that the income elasticity of demand for petroleum has fallen, indicating that fuel saving measures have



proved successful. The rise in petroleum prices nevertheless adversely affected the commodity terms of trade as import prices rose. However, the income terms of trade soon recovered, reflecting the rise in export volume.

Although most Cypriot trade was with the United Kingdom before independence, both exports and imports have been less geographically concentrated in recent years. The United Kingdom's accession to the European Community threatened Cyprus' major export market, but it was hoped that the association agreement signed in 1972 with the European Community would promote the island's trade. In practice export sales to the European Community have proved disappointing, partly because of the Community's quotas on imports of garments and other manufactured goods, and the preferences given to Community producers through the Common Agricultural Policy. Cyprus has enjoyed more success in the markets of the Arabian Peninsula, and in this sense the oil price rises have resulted in a positive feedback effect. The large trade surplus with some Arab states partly compensates for the trade deficit with the European Community, but the working of the association agreement remains unsatisfactory from the Greek Cypriot point of view.

The invisible trade position remains healthy despite the decline in the value of foreign military expenditure in real terms. Earnings from tourism fell dramatically in the mid 1970s due to the oil price rises, and more significantly, the Turkish invasion, but they have since recovered. By 1978 tourism has become the largest single source of invisible earnings. Both private and social returns are high from investment in tourism, one measure of the latter being the foreign exchange receipts per unit of investment. The Greek Cypriot tourist industry remains overdependent on visitors from the United Kingdom, but in recent years many expatriates from the Arabian peninsula have been tempted to take short periods of leave on the island. Given



the promising prospects for tourism, it seems likely that the invisible trade surplus should be able to accommodate the visible trade deficit for the foreseeable future.

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March 1985.

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26. The author carried out such an exercise to compare the returns on investment in agriculture and industry over the 1975-77 period. Industrial investment yielded the higher returns, averaging over 10 per cent.

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